

UNITED STATES OF AMERICA
Before the
COMMODITY FUTURES TRADING COMMISSION

In the Matter of:

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) **CFTC Docket No: 01-13**
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New York Futures Exchange, Inc.
Four World Trade Center
New York, NY 10048

)
) **ORDER INSTITUTING**
) **PROCEEDINGS PURSUANT TO**
) **SECTIONS 5b, 6(b) AND 6b OF THE**
) **COMMODITY EXCHANGE ACT,**
) **MAKING FINDINGS AND**
) **IMPOSING REMEDIAL**
) **SANCTIONS**
)

Respondent.

I.

The Commodity Futures Trading Commission (the “Commission”) has reason to believe that New York Futures Exchange, Inc. (“NYFE”) has violated Section 5a(a)(8) of the Commodity Exchange Act (the “Act”), 7 U.S.C. § 7a(8) (1994),¹ and Sections 1.51(a) and 1.53 of the Regulations, 17 C.F.R. §§ 1.51(a) and 1.53 (2000). Therefore, the Commission deems it appropriate and in the public interest that public administrative proceedings be, and they hereby are, instituted to determine whether Respondent engaged in the violations set forth herein, and to determine whether any order should be issued imposing remedial sanctions.

II.

In anticipation of the institution of an administrative proceeding, NYFE has submitted an Offer of Settlement (the “Offer”), which the Commission has determined to accept. Without admitting or denying the findings of fact in this Order and solely for the purpose of resolving this proceeding, the Respondent acknowledges service of this Order Instituting Proceedings Pursuant to Sections 5b, 6(b) and 6b of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions (“Order”), and NYFE consents to the use of the findings in this Order in this

¹ As of December 2000, the Act was amended. See, Commodity Futures Modernization Act of 2000, Appendix E of Pub. L. No. 106-554 (2000). However, as all activities discussed herein occurred prior to December 2000, all violations cited are of the Act, as amended in 1994.

proceeding and in any other proceeding brought by the Commission or to which the Commission is a party.²

III.

The Commission finds the following:

A. SUMMARY

From at least August 1999 to May 12, 2000, the NYFE, a contract market designated by the Commission for trading, among other things, options on the PSE Technology Index futures contract ("P-Tech Options"), failed to enforce its rule for determining settlement prices for P-Tech Options.

B. RESPONDENT

New York Futures Exchange, Inc. is a New York corporation with its principal place of business at Four World Trade Center, New York, NY 10048. NYFE is a duly designated contract market for trading P-Tech Options.

C. FACTS

1. NYFE's Settlement Procedures

At all times during the relevant period, NYFE Rule 315, which regulates how settlement prices on NYFE contracts are to be determined, was in full force and effect. NYFE Rule 315 provides procedures by which the settlement prices shall be calculated at the close of the trading day.³

² NYFE does not consent to the use of the Offer or this Order, or the findings to which it has consented in the Offer, as the sole basis for any other proceeding brought by the Commission or to which the Commission is a party other than a proceeding brought to enforce the terms of this Order. NYFE does not consent to the use of the Offer or this Order, or the findings to which it has consented in the Offer, by any other person or entity in this or any other proceeding. The findings to which NYFE has consented in the Offer, as contained in this Order, are not binding on any other person or entity named as a respondent or defendant in this or in any other proceeding.

³ NYFE Rule 315 provides:

The settlement price for each contract, other than expiring contracts on the last day of trading, shall be determined as follows:

(a) The settlement price shall be the average of all prices of the closing range of the contract involved. When an average is a fraction, the settlement price shall be the next full trading point above or below the fractional average depending on which is nearer the last price recorded.

(b) If, for any contract, no transactions have been executed during the respective closing period, the settlement price for such contract shall be the average of the highest bid and the lowest offer during such closing period; provided, however, that a bid or offer which is out of line shall not be considered.

During the relevant time period, NYFE appointed members to a settlement committee (the “Settlement Committee”) for the purpose of setting all NYFE option contract settlement prices in accordance with NYFE Rule 315. By informal agreement among the members of the Settlement Committee, one particular Settlement Committee member (the “Member”) was assigned to settle the P-Tech Options contract on a daily basis. The Member was assigned because he was an active trader in the P-Tech Options market.

Under normal circumstances, settlement prices are calculated from market bid-ask spreads supplied by market makers, from which implied volatility can then be determined. Rather than letting market forces determine the price and thereby the implied volatility for each month’s P-Tech Options, the Member selectively set volatility levels for each month’s options. The volatility set by the Member resulted in all months’ settlement prices being determined based on that volatility. The volatility level set by the Member continued in effect until changed by the Member, adjusted only by the change, if any, in the settlement price for the underlying futures contract for the applicable month. At the end of every trading day during the relevant period, NYFE reported the settlement prices for each P-Tech Options contract.⁴

2. NYFE’s Failure to Enforce Its Own Rule

From at least August 1999 to May 12, 2000, the Member, and thereby the Settlement Committee, failed to use any of the methods set forth in NYFE Rule 315(a-c) to settle the P-Tech Options contract. Accordingly, pursuant to NYFE Rule 315(d), the Member, and thereby the Committee, was required to “prepare a written record setting forth the basis for such settlement.” The Member and the Committee failed to prepare such written record.

NYFE had no procedure in place by which it could ensure that the Settlement Committee complied with NYFE Rule 315 beyond NYFE’s reliance upon self-policing by the Settlement

(c) If there are no bids and offers for a contract during its closing period, the settlement price shall be determined by reference to the prevailing differences between such contract and the nearest active month of the respective contract market during the day in the case of a future, and the nearest active strike price of the same series in the case of an option.

(d) If a settlement price derived by employing the foregoing procedures is not consistent with trades in other months during the closing range or with market information known to the Futures and Options Contract Committee, the Committee may establish a settlement price at a level consistent with such other trades or market information and shall prepare a written record setting forth the basis for such settlement.

(e) Notwithstanding the foregoing provisions of this Rule, on any day on which a cessation of trading of the NYSE Composite Index Futures contract pursuant to the Rule governing trading halts and daily price limits shall be in effect at the close of trading, the settlement price for each NYSE Composite Index Futures contract shall be at such expanded price limit as is applicable pursuant to said Rule.

⁴ Settlement prices are used, among other things, by clearinghouses to calculate the variation margin of its clearing firms, which is the difference between the settlement price and the trade price or, for a current position, the previous day’s settlement price.

Committee and other market participants. NYFE did not take any independent action to review the Settlement Committee's compliance with Rule 315.

D. LEGAL DISCUSSION

Section 5a(a)(8) of the Act and Section 1.53 of the Regulations require each contract market to enforce all bylaws, rules, regulations, and resolutions made or issued by it or by the governing board thereof. Section 1.51(a) of the Regulations provides that each contract market shall use due diligence in maintaining a continuing affirmative action program to secure compliance with Section 5a(a), among other provisions. Section 1.51(a)(6) specifically provides that such program shall include surveillance, record examination and investigation as is necessary to enforce its bylaws, rules, regulations and resolutions.

NYFE failed to enforce NYFE Rule 315 and failed to use due diligence in maintaining a program to secure compliance with NYFE Rule 315, all in violation of Section 5a(a)(8) of the Act, 7 U.S.C. § 7a(8) (1994), and Sections 1.51(a) and 1.53 of the Regulations, 17 C.F.R. §§ 1.51(a) and 1.53 (2000).

IV.

NYFE represents that it has instituted procedures to improve its ability to secure compliance with NYFE Rule 315 for each of the NYFE contracts. Specifically, NYFE has enhanced procedures in three main areas: 1) risk management, 2) recordkeeping, and 3) computer programming.

First, New York Clearing Corporation, the clearinghouse for NYFE, has hired an options specialist to assist in the area of risk management. One function of the options specialist will be to review the options settlement prices of, among others, NYFE contracts, the data from the computer program as described below, the implied volatilities, historical volatilities, comparable indices, and position information, as a test of the NYFE options settlement process.

Second, NYFE has instituted enhanced recordkeeping practices for the options settlement process. In particular, NYFE now requires the sign-off of tasks performed in the options settlement process by the Settlement Committee members. The records created in the options settlement process are also now uniform for all NYFE contracts, and maintained in a central location.

Third, NYFE is in the process of making improvements to its options settlement computer program. The computer program is being upgraded to enhance the options settlement pricing function. The program itself will be keeping track of bids and offers and trade data occurring on the close as they pertain to options settlement pricing. The program also will record volatility changes from day to day, and will eventually compare volatilities from month to month, thereby diminishing the risk of human error or manipulation of the settlement prices. The computer program also will keep an internal audit trail of the computer users and the data input, and requires a password for access, which is only provided to authorized staff.

NYFE has represented to the Commission that it will complete and continue to maintain these recently instituted procedures. Consistent with these efforts by NYFE to correct earlier problems with its enforcement of NYFE Rule 315, NYFE provided substantial cooperation to the Commission during the course of the Commission's investigation of this matter.

V.

OFFER OF SETTLEMENT

NYFE has submitted an Offer of Settlement in which, without admitting or denying the allegations or the findings herein, it: acknowledges service of this Order and admits the jurisdiction of the Commission with respect to the matters set forth in this Order; and waives: (1) the service and filing of a complaint and notice of hearing; (2) a hearing and all post-hearing procedures; (3) judicial review by any court; (4) any objection to the staff's participation in the Commission's consideration of the Offer; (5) all claims which it may possess under the Equal Access to Justice Act, 5 U.S.C. § 504 (1994) and 28 U.S.C. § 2412 (1994), as amended by Pub. L. No. 104-121, §§ 231-32, 110 Stat. 862-63, and Part 148 of the Regulations, 17 C.F.R. §§ 148.1, *et seq.*, relating to or arising from this action; and (6) any claim of Double Jeopardy based upon the institution of this proceeding or the entry in this proceeding of any order imposing a civil monetary penalty or any other relief.

NYFE stipulates that the record basis on which this Order is entered consists of the Order and the findings to which NYFE has consented in its Offer, which are incorporated in this Order. NYFE consents to the Commission's issuance of this Order, which makes findings as set forth herein, and orders that NYFE pay a civil monetary penalty of seventy-five thousand dollars (\$75,000) within ten (10) business days of the entry of this Order.

VI.

FINDINGS OF VIOLATIONS

Solely on the basis of the consent evidenced by the Offer, and prior to any adjudication on the merits, the Commission finds that NYFE violated Section 5a(a)(8) of the Act and Sections 1.51(a) and 1.53 of the Regulations.

VII.

ORDER

Accordingly, IT IS HEREBY ORDERED THAT:

NYFE shall pay a civil monetary penalty of Seventy-Five Thousand Dollars (\$75,000). Payment is to be made by electronic transfer to the account of the Commodity Futures Trading Commission at the United States Treasury, or by U.S. postal money order, certified check, bank cashier's check or bank money order, made payable to the Commodity Futures Trading Commission, and sent to Dennese Posey (or her successor), Division of Trading and Markets,

Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, N.W., Washington, D.C. 20581, under cover of a letter that identifies NYFE and the name and docket number of the proceeding; NYFE shall simultaneously transmit a copy of the cover letter and of the form of payment to Phyllis J. Cela, Acting Director, Division of Enforcement, Commodity Futures Trading Commission, 1155 21st Street, N.W., Washington, D.C. 20581.

By the Commission.

Catherine D. Dixon
Assistant Secretary to the Commission
Commodity Futures Trading Commission

Date: July 11, 2001